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Remarks of
Chairman James J. Hoecker
Federal Energy Regulatory Commission

"Consumer Confidence In Wholesale Markets"

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I.

I last addressed NASUCA during its March 2000 Capitol Hill Conference. That seems very long ago, viewed through the prism of today's energy problems. The Commission had recently issued Order No. 2000, which is designed to change the electric utility industry by vertically disaggregating utility functions in support of non-discriminatory regional grid services and by clearing away the underbrush of pricing barriers and congestion across multiple transmission systems, promoting regional planning and reliability, and

infusing the market with better real-time information. We see a future for electricity in which a patchwork of locally-determined retail market conditions are facilitated by a more efficient, more transparent, and fairer interstate network industry which facilitates the movement of power to where it is most needed. Bulk power competition, I maintain, will deliver benefits for consumers if we are allowed to get there. But, Order No. 2000 recognized that the industry must restructure to accommodate the operational and economic developments in the physical market itself. With Order No. 2000, we felt the Nation had taken a very large step.

This year the Commission also completed an important initiative for the interstate natural gas pipeline market, Order No. 637. That order advances an already mature mid-stream gas transportation market –- open access and service unbundling in gas pipeline markets are many years older than across the

Commission-regulated electric transmission system –- by allowing market rates for pipeline capacity sold in the secondary market and providing greater flexibility in the rates of transportation service. As it turns out, the natural gas infrastructure is also becoming critically important to ensuring electricity supply and reliability in many regions of the country.

Finally, by early 2000 the Commission had finished a two-plus year restructuring of its own, developing new processes for speed and accuracy for performing most basic staff work in a team environment, initiating a market monitoring capability so that we might keep up with these competitive markets we have created, and combining our gas and electric expertise to more closely mirror the market. FERC is now a more customer-oriented, market-responsive organization as a result of this re-invention effort.

FY 2000 was a very successful year for the Commission by most measures. It is never easy for an agency of our size to be engaged in this level of multi-tasking without a loss of focus or productivity, but we pulled it off. Well, as you might suspect, no good deed goes unpunished!

II.

Since early summer, we have had to focus our greatest attention and significant resources on energy markets that have produced escalating prices for consumers. On the gas side, we began reaping the consequences of the 1998 oil and gas price collapse and the precipitous decline in production that followed it. Beginning in May, natural gas prices moved quickly from \$2 per MMBtu to \$5 per MMBtu. Diminished supplies slowed the fill rate for winter storage and the start-up of additional gas fired generation put additional pressure on price. Supplies are very tight in this state right now. For the first time in several years, Congress cordially invited me to the Hill to talk about the condition of the gas industry and the forthcoming financial burden on consumers.

At the same time, electric reliability and prices in California also became far less predictable. After two years of struggle to create a market, including the historically high electricity demands of the summer of 1999, California's restructured market was delivering reliable power at a declining price. According to July's Public Utility Fortnightly, California's prices were lower than PJM's for the 12-month period before April 2000. Suddenly, California's peak season prices skyrocketed. Under California law, SDG&E was able to simply pass the pain onto its retail customers. As our staff investigation later showed, long-term trends and unusual events had finally caught up with the California market. I seldom claim to be prophetic, but I told you in March that "[i]t appears to me that no combination of grid expansion, additional generation, and load shedding will be sufficient to avoid a high level of stress this summer and perhaps next." That now looks like an understatement. In fact, the "stress" in California turned into near meltdown.

What we subsequently came to understand was that California's demand had grown over 5000 megawatts since 1995 and only 700 megawatts of generation had been added in that time. The state's system would have weathered the summer demands on it better but for high electricity demand occasioned by unusually hot weather and abnormally low hydro conditions across the rest of the West. Added to this supply/demand imbalance was: (1) the operation of California law, which effectively kept retail competitors out of places like San Diego and then suddenly flowed through to retail customers all the volatility at the wholesale level with no warning;(2) the extraordinary reliance on the spot markets to set the price; and (3) market rules that were highly changeable and perhaps capable of being gamed. Extraordinary market prices do not seem, in hindsight, to be anything but inevitable.

Because of the fallout from this unhappy confluence of factors, policymakers and citizens alike began to question whether markets for power could work anywhere at all. Needless to say, I subsequently received many additional invitations to appear before Congress. California has had a powerful dampening effect on a restructuring process that, for all its fits and starts, was showing great promise in about half the states, in bulk power prices, and in the process of RTO formation. I believe California teaches us to be more, not less, aggressive -- but not more prescriptive -- in pursuit of better markets.

The Commission has held two hearings in San Diego this fall, the latest being this morning. I expect that we will undertake some strong corrective measures and we should do so by the end of the year in anticipation of next summer's peak. We propose to force more forward contracting, diminish reliance on the spot market by curbing under-scheduling, reconstitute the ISO board, expand bilateral transactions, and so forth. Some of this comes at the expense of AB 1890, I am afraid. However, it is remarkably hard to find defenders or owners of that legislative scheme these days.

When I spoke to NARUC yesterday, I decided to make clear the Commission's role in helping create the current difficulties. Quite frankly, I confessed error -- on behalf of the Commission, if I may be so presumptuous -- for working so very hard to implement a single-state bulk power market, designed by progressive and well-intentioned lawmakers to help jump-start the Californian economy, and then carved into California law without flexibility, the benefit of technical experience, or a recognition of its regional significance.

To tell the truth, the Commission was delighted at the time that any state would so boldly advance the cause of competition consistent with transmission open access, even though it was legislating on territory subject to the Federal Power Act. As even our Order No. 888 open access rule made clear, the Commission was fully prepared to defer to the states down the line, in part not to appear preemptive on electric issues. I also thought at the time that, since California had created the ISO and PX, the mandatory buy-sell requirements, and the rate freeze would also be able to protect retail electricity consumers, as it always had. I doubt the Commission will ever rely on that assumption without question again. Shame on us if we do.

Of course, the trends and predicaments that led to California's problems are not altogether unique. Between 1995 and 1999, domestic demand for electricity increased 9.5 percent, while total additions to generation rose 1.6 percent. At the same time, utility expenditures for energy efficiency declined by 50 percent, magnifying the problem of demand growth. In addition, EPRI believes that North America is "on the edge" when it comes to the threat of severe power outages. And, DOE has warned against the growing concentration of electricity supply in the hands of a few companies and the high prices that could ensue. So, the situation for this industry mid-transition is still fraught with challenges for regulators and consumers.

I hasten to add that the restructuring story thus far is not a bad one, notwithstanding the California crisis. Electricity rates have declined nationally in each of the last six years. And, as I mentioned, California's new market has lowered rates and maintained reliability in the face of growing demand during most past periods. Until this summer, many had the feeling we were really getting somewhere!

Here in San Diego, the issue that overwhelms all others –- the elephant in the room, so to speak –- is the matter of whether the Commission can, or should, order refunds from generators who charged market-based rates throughout the West last summer. They are alleged to have "gouged" consumers because the market was sufficiently dysfunctional for the Commission to conclude it had either produced, or had the potential to produce, unjust and unreasonable rates. There is much, much more we need to find out about market behaviors. The results, if not the legality, of what occurred are readily apparent, however. This seems to me to be a kind of ultimate consumer protection issue. San Diegans were exposed to dramatic rate increases without warning and without any supply alternatives. Administering a federal statute whose primary goal is to ensure rate certainty, however, the Commission concluded that retroactive refunds were impermissible. Actually, I am unaware of any regulator with such authority. So, the Commission did not even get to the enormously complicated logistical problem of how we would determine the excessiveness of rates, who received the revenues, and how we would redistribute any refunds. On this issue, the Commission finds itself caught in the unenviable and ironic position between well-established regulatory law and the consumers that the law otherwise seeks to protect. It makes us an easy target.

California's crisis has, among other things, heightened the Commission's awareness of the consumer consequences of its actions and those of developing markets. Unlike the natural gas industry, where interstate markets worked through the maturation process outside the city-gate and in relative isolation from retail markets, electricity markets are vertically and geographically more highly integrated and prices seem to ripple more readily through the system and down to consumers. In a competitive market, this can be a good thing, not a problem, however. It is clear to me that, as we try to accommodate and channel the forces of the 21st century electric industry, our agency has a heightened responsibility for those at the end of the value chain, whom we at the federal level have tended to assume (rightly or wrongly) are someone else's primary responsibility.

There are plenty of revelations to go around, however. I think there is a corresponding new responsibility for state officials, and state regulators in particular. It is to ensure that the regional energy markets that serve and surround their states perform well for everyone in the region, and not just their constituents. I am hoping that NASUCA, which has long understood the benefits of RTOs and competition for consumers, will reinforce this message. It is a key point that most state regulators may not be hearing, I am afraid.

In addition to hearing the passionate and difficult stories we heard this morning about plant closings, about senior citizens choosing between food and electricity, about schools and hospitals that were torn between paying utility bills and providing essential services, we had the honor of discussing these problems and potential solutions with Governor Davis and other state officials. Having just come from that session, I am still digesting what we heard. There is, quite predictably I suppose, a degree of apprehension about the Commission and the impacts of its proposed market reforms. Those proposed reforms are not yet well understood in California and our panelists this morning asserted we are merely sanctioning ever-escalating rates. Just as within the Commission itself, a focal point of debate –- between the view that markets have to be able to tell ratepayers what the real value of their service is and the view that volatility in the market is unacceptable and that limiting its excesses is a financial and moral necessity –- is rate caps.

But, if there is a consensus here, it is that the Commission should intervene to protect consumers from this unmanageable market.

I also heard at the same time that the entire power market in this state is California's to govern and that any such solutions have to be home grown, not the verdict of a distant federal bureaucracy or the determinations of ISO "technocrats." In other words, it would seem that, having legislated the wholesale as well as the retail market into existence and endured the consequences, California now appears to be seeking an opportunity to repeat that history. Although no state plan yet exists, such a proposal, when formulated, would do well to recognize the principle that governance of the grid administrator must be independent of market participants and other undue influences as well as recognizing the needs of the regional market in the West. An efficient and open market will generate the capital and foster the system

coordination needed to serve the demands of California consumers better. There is no more important objective for that state's capacity-starved economy. But it seems to me that the claim of California's officials that the ISO must be politically accountable tends to discount or disregard the multi-state nature of the power market that serves the state at wholesale. On the other side of the ledger, the sellers of electricity in California, whose extraordinary quarterly earnings reflect the flip-side of California's pain, have not proposed how to address the very real possibility of a consumer and political backlash that could jeopardize or reverse progress toward competition.

In any event, the participation of this highly focused and energetic Governor in any discussion of this technical subject matter is cause for optimism. Lord knows, there is plenty to be done by both the CPUC and the FERC to get this market out of the ditch. At any rate, I sincerely hope that we advanced the cause of state-federal collaboration.

III.

The challenges are not insurmountable. However complex and numerous are the issues needing attention. The fundamental choices seem to me to boil down to two -– either proceed more quickly and effectively through this difficult transition or retreat and retrench. Given the fundamental changes that are already taking place across America's electric systems, stopping the accompanying development of pro-competitive policies and waiting for markets somehow to become competitive on their own hardly seems a practical solution. Market dynamics and state and federal policy decisions have created a different set of circumstances than that which existed five or ten years ago. Utilities are reconfiguring, consolidating, plunging into unregulated enterprises, and selling assets. Others have taken on the task of expanding the infrastructure and developing the markets. While the Commission can still resort to traditional cost-of-service regulation, its ability to protect and benefit consumers is now more directly proportional to its ability to react to markets in real time, to be able to curb market power abuses, and to correct bad market rules. From time to time, the Commission will have to restrict and limit market volatility or even impose regional market institutions. If California has taught us anything, it is that market developments may still require regulatory intervention under the law when consumers' welfare is severely and unexpectedly jeopardized.

The Commission must move forward, in my estimation. It must do so in cooperation with states and a full understanding of the affected retail markets. I agree with Governor Davis that erratic and exploitative electricity markets will lose consumer confidence, then political support, and finally any competitive justification. We must do better. The Commission is committed to improving the Western power markets next month, next summer, and in the long run. However, the State of California must do its important and appropriate part. We stand ready to help the CPUC and the California Energy Commission discharge their respective roles. There is tremendous urgency in all this.

We are entering difficult times in this transition to a more open and competitive market, times that will be marked by second thoughts about what everyone seems to want to call "deregulation." While there's something a bit disquieting about being both a consumerist and a promoter of markets at this particular moment in time, we <u>must</u> be both. What is needed to move ahead in this area is, I admit, more than a pro-competition sales job and more than blind faith that the market will make this all work out in the end. There are powerful and legitimate consumer concerns here. There are therefore hard choices to make and hard work to be done.

In such an environment, the Commission needs to be reminded by its critics and its friends alike that it must discharge its responsibility to protect the interests of all consumers -– the small as well as the large -- as it promotes competition in electricity markets. Beyond the business and macro-economic developments, restructuring is also a human event, a "small p" political process, and an educational challenge. NASUCA has been important to us in times past, for example in reinforcing our conviction that RTOs are in consumers' best interest and that the Commission must lead on such issues. Keep the pressure on us to move in directions that make both economic sense and common sense in the minds of average Americans. That's a difficult regulatory challenge in a time of transition. But we will meet that challenge if we continue to have your good counsel. And, the

Congress needs your good counsel as well, especially when it comes to giving us the tools we need to protect consumers during this difficult time. Please keep those cards and letters coming in.

Thank you.